

**Regulatory Accounting Guidelines**

**Report to Ofgem**

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**Deloitte & Touche  
Hill House  
1 Little New Street  
London EC4A 3TR  
United Kingdom**

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## **1. EXECUTIVE SUMMARY**

Deloitte & Touche were commissioned by the Office of Gas and Electricity Markets (“Ofgem”) to reassess the guidelines used by distribution businesses operating in the Great Britain electricity industry in compiling their Regulatory Accounting (“RA”) returns. The returns are a requirement under the terms and conditions of each Public Electricity Supplier (“PES”) Licence. The scope of our work was limited to the following:

*“To create a set of regulatory accounting guidelines that will be consistent across all the distribution businesses of the 14 PES’s of Great Britain, and will facilitate the comparison of the regulatory accounts to the assumptions underlying the distribution price control. The main focus of the work will be on the following issues:*

- *Allocation of overheads;*
- *Internal recharges; and*
- *Capitalisation policies”.*

### **1.1 Deloitte & Touche consultation process**

A key ingredient in this project has been Deloitte & Touche’s consultation with Ofgem and with the distribution businesses. This consultation process allowed the companies themselves, the regulator and Deloitte & Touche to engage in open and constructive discussions about the issues that are of concern to industry participants, and for the industry to better understand Ofgem’s perspectives.

### **1.2 The Regulatory environment**

Under the Utilities Act 2000, PESs will be obliged to ring-fence their distribution businesses within a separate legal entity. That will, through the application of the Companies Act 1985, necessitate the production of statutory accounts for the ring-fenced distribution business in accordance with UK Generally Accepted Accounting Principles (“GAAP”).

### **1.3 Industry developments**

The last Distribution Price Control Review (“DPCR”) was conducted in 1998 – 1999. A number of events have occurred since then that should naturally simplify the processes needed for Ofgem to carry out its monitoring role.

In particular, the regulatory separation of distribution and supply businesses, means that clearly defined statutory entities should operate the distribution businesses. There should not be a need to extract data from large consolidated corporate groups in the future as each distribution business will prepare statutory accounts. That should simplify the data extraction issue that arose during the last Business Planning Questionnaire (“BPQ”) preparation. However, issues such as related party transactions will remain.

## **1.4 New structures in the industry**

Another development of significance is the advent of new organisational and commercial structures, primarily the establishment of joint-ventures and external contracting companies to carry out services formerly performed by the entity itself. These could alter the balance between allocation of overheads and capitalisation, as costs that, in the past, were treated as overhead will now return directly through the charges made under a contract or agreement.

## **1.5 General principles applicable to the Regulatory Accounts**

During the course of the Regulatory Accounting Guidelines (“RAGs”) project conducted by Deloitte & Touche, a number of issues were raised by PESs or Ofgem. Following consultation and decision-making by Ofgem, some of these issues are clarified below.

- RAs will be prepared on the basis of UK Generally Accepted Accounting Principles (“GAAP”) for a London Stock Exchange listed company. Ofgem has indicated that the disclosures outlined under ‘Turnbull’ will be required, but this does not mean that such requirements as an Audit Committee are to be put in place;
- Inter-group recharges, Service Level Agreements (“SLAs”) and other contractual arrangements with associated companies – be they internal or external by way of joint venture – must demonstrate arm’s length trading, no cross-subsidy and be transparent;
- The need to reconcile data back to the price control must be a key driver in the relationship between Ofgem’s RAGs and the output from distribution businesses;
- The process will be impacted by changes in the ways that companies capitalise as a result of FRS-15 and internal changes in accounting policy;
- A clearer result will follow on from the steps taken during this process to overcome the difficulties in comparing information. During the last DPCR, such difficulties arose through inconsistent classification and reporting of activities. During the consultation process, a definition of a distribution business was developed that clearly outlines the activities and services to be included. Distribution businesses will be expected to report their RAs to Ofgem on the basis of the general activity splits. Doing so will drive further consistency into the RA process; and

- As outlined in Ofgem’s “Regulatory Accounting – Final Proposals” released in November 2000, (Section 3.14) Current Cost Accounting (“CCA”) is to be dropped in favour of Historical Cost Accounting (“HCA”) reconciled to Regulatory Asset Value (“RAV”) and the Statutory Accounts. RAV will be assessed on the basis laid out in Ofgem’s December 1999 Final Proposals.

## 1.6 Summary of points following second consultation meeting

Deloitte & Touche issued a draft paper in December 2000 and sought feedback from each industry participant and Ofgem to that draft. The responses by the individual businesses can be grouped into a number of common themes - General Agreement, General Disagreement or Concern.

To ensure that the process remains transparent and to reassure all parties that their responses to Deloitte & Touche have been considered, each of the key common themes raised is outlined as follows:

### 1.6.1 Key Common Themes - General Agreement between the businesses

Issue	Discussion
Historic cost accounting	General support for producing accounts using historic cost principles.
Use of UK GAAP	The use of UK GAAP is encouraged.
Need for some form of regulatory accounts	Agreement that statutory accounts and additional information for performance review and price control purposes is required.
Reconciliation of Regulated Asset Value (RAV) To Historic Cost Asset base (HCA)	This reconciliation is considered necessary and should be provided to Ofgem, however, the industry states that Ofgem needs to provide the base information to allow this to happen.
Activities	The use of activity costings and particularly those outlined in the document is considered reasonable and encouraged. However, the basis for that activity analysis may not be the same in all distribution companies.
Related party disclosure and transactions	Subject to clarification of issues raised re publication, materiality, availability of market testing purposes and use of independent experts, there is consensus that the treatment and monitoring of related party transactions should mirror that adopted by Ofwat.
December to March reconciliation	Given that the regulatory year is set as an April-March financial year, those companies with December year end dates will need to reconcile between March and December. All companies indicated that this is feasible.
Capitalisation policies	To meet Ofgem's requirements, disclosure of capitalisation policies for operation and non-operational capital expenditure is considered appropriate.
Allocation of overheads	Overheads should be allocated on the basis of a reasonable estimate of the different workloads or underlying activities.

## 1.6.2 Key Common Themes - General Disagreement

Issue	Discussion
Separate statutory and regulatory accounts	The production of separate accounts for statutory and regulatory purposes requiring considerable reconciliations between the two is considered by the industry to be undesirable and onerous.
Prescriptive accounting policies	Imposing prescriptive accounting policies would lead to additional costs re consumers and perverse incentives.
Total Cost benchmark	Many in the industry felt that a Total Cost benchmark would be a better method to assess performance and would encourage Ofgem to move to it.
Capitalisation rules	Prescriptive capitalisation rules will in all likelihood produce perverse incentives to misinterpret these rules.

## 1.7 Proposals presented to Ofgem by D&T

As a result of the consultation process with all parties, Deloitte & Touche presented three options for consideration by Ofgem. Each of these will, to varying degrees of detail, make the RAGs more consistent and comparable. Each should also simplify the process by which Ofgem and the Distribution businesses track performance against the last DPCR and inform future DPCRs.

*General agreement was reached at the 13 December 2000 Consultation Meeting that Deloitte & Touche's proposed Option Two was the alternative that satisfied the widest range of viewpoints.*

However, the three options are restated below for clarity.

### 1.7.1 Option One – Define the information required from the Distribution businesses but not the detailed accounting methodology

Deloitte & Touche believes that changes in the industry, and the advent of new accounting standards, have created the circumstances where Ofgem could rely on the individual companies to provide information that meets the RA requirements and is compliant with UK GAAP. Under this scenario, auditors would then provide assurance by way of the issued opinion.

An enhanced degree of consistency will naturally arise in future versions of the RAs because of business separation, the full application of FRS-8, FRS-12 and FRS-15, and the issuing of a specific licence to distribution businesses as statutory entities. Each of these in turn reduces the scope for interpretation and thereby reduces inconsistency in the RAs.

Option One specifies the additional information required but leaves the method of measurement for the directors of the companies to define within the confines of UK GAAP. This approach reflects the view that it is not for Ofgem to iron out imperfections and variability in accounting measurement.

Under this approach the regulator accepts the audited UK GAAP measurements and leaves the market (i.e. the companies choosing the measurements they consider most suitable) and the accounting and auditing regulatory processes (Accounting

Standards Board (“ASB”), Urgent Issues Task Force (“UITF”), Financial Reporting Standards (“FRSs”) and Statements of Recommended Practice (“SORPs”)) to regulate and improve UK GAAP.

### **1.7.2 Option Two – Option One PLUS mandates of particular measurement techniques**

Option Two recognises that, in the past, the variability available to companies in their application of accounting policies has been too great and has created inconsistencies throughout the RAs process.

Under this option, Ofgem would stipulate the required accounting treatment in certain key areas, principally those that were contentious or difficult at the last DPCR. An example might be a prescribed treatment of the capitalisation of overhead line and underground cable expenditure.

These requirements will, to all intents and purposes, form a type of Regulatory GAAP specific to the distribution business RAs. However, that is in accordance with Ofgem’s belief that the RAs are ‘compliance statements’ which stand apart from and are not necessarily required to be in accordance with UK GAAP.

### **1.7.3 Option Three – Option Two PLUS a prescription of main accounting policies to be applied**

Under Option Three, in addition to the information and disclosures referred to in Option Two, Ofgem would issue a set of main accounting policies to be used by each company and all companies would be required to prepare their RA returns on that basis.

Divergence from these policies would only be permissible on pre-approval in writing from Ofgem. Provided that such authorisation was obtained, the company would be required to disclose the following within their notes to the RA:

- a) The reasons for making such a change; and
- b) The financial effect of the change on current year’s earnings and net assets.

## 1.8 Benefit Analysis of options as presented

Deloitte & Touche consider the relative merits of each option as follows:

Option	Positive	Negative
<b>One</b>	<ul style="list-style-type: none"> <li>Utilities Act 2000 aligns the legal entity with the statutory accounts</li> <li>Application of recent FRS's will eliminate a degree of inconsistency through reduction in scope for interpretation</li> <li>Allows company boards to select and implement the accounting policies they deem most appropriate for their business</li> <li>Lower compliance costs for distribution businesses</li> <li>Enables auditors to express a 'true &amp; fair view'</li> </ul>	<ul style="list-style-type: none"> <li>Scope for inconsistency between distribution businesses may still exist</li> <li>Companies will choose policies most favourable to their own needs</li> <li>Lack of clarity &amp; transparency may still exist</li> <li>Disputes will arise at time of DPCR</li> <li>Will not meet all of Ofgem's requirements</li> </ul>
<b>Two</b>	Positives as per Option One plus: <ul style="list-style-type: none"> <li>Consistency of information should be improved</li> <li>RAGs will focus on the key areas</li> <li>Industry prepares RAs and Ofgem review responses which should equal efficient use of regulator's resources</li> <li>DPCR may be simplified</li> <li>Risk of unanticipated outcomes should be reduced</li> <li>Less interpretation risk for all parties</li> </ul>	<ul style="list-style-type: none"> <li>Increases compliance costs</li> <li>Ofgem selects appropriate policies on accounting issues</li> <li>Ofgem will need to review the RAGs for changes in UK GAAP.</li> <li>Will create potential for two differing accounting results between statutory accounts and regulatory accounts</li> <li>Distribution businesses will choose behaviour that best exploits Ofgem's rulings</li> </ul>
<b>Three</b>	Positives as per Option Two plus: <ul style="list-style-type: none"> <li>Consistency of information should be further improved</li> <li>Ofgem has the flexibility to establish accounting policies that suit its price control needs</li> <li>Designed to align all major areas of accounting policy</li> </ul>	<ul style="list-style-type: none"> <li>Could be perceived as Ofgem being too prescriptive</li> <li>May not take the unique differences of some PESs into account</li> <li>May restrict the ability of PESs to establish effective operating procedures and policies that drive down costs</li> </ul>

## 1.9 Summary of options

Essentially the choice between Options One, Two and Three is between attempting to strike a balance between increasing the consistency of information returned and minimising the creation of an environment that encourages distorting behaviour, with consequent distorted results.

Attempting to force RAs to be presented in a consistent format through the application of the same accounting policies across the board does not in itself take account of the different environments in which each distribution business operates and could, therefore, lead to market distortion. Such an approach could also reduce the ability of each distribution business to create and adopt competitive advantage, whether that be through new structures or cost-control methods.

## **1.10 Conclusion**

Given that it appears to be the most suitable compromise, potentially delivering the required information to Ofgem for its monitoring and informing purposes, as well as clarifying the way forward for the companies within the industry, Deloitte & Touche recommend that Ofgem and the industry work closely together to create an RAs framework within the outline of Option Two.

This means that Ofgem provides guidance to the companies on how they should treat costs within the three key areas that caused difficulties in comparisons at the last DPCR. Deloitte & Touche believes that the successful adoption of Option Two will be dramatically enhanced should Ofgem decide to further consult with the industry in order to fully evaluate a workable ‘activities’ split that takes account of the needs and structures of both information providers and receivers.

The final decision on the framework for the RAGs lies with Ofgem and we believe a working draft is currently being discussed. During this process we recommend Ofgem considers the detailed proposals presented within the remaining sections of this report.

## **2. NEW GENERAL PRINCIPLES GUIDING THE REGULATORY ACCOUNTS**

### **2.1 UK GAAP for a London Stock Exchange listed company**

Deloitte & Touche's view is that the RAGs should comply with UK GAAP for a London Stock Exchange listed company. However, in certain circumstances there may be a justification for alterations to ensure appropriate and relevant information is provided to the regulator. Where RAG differ from UK GAAP, RAGs will take precedence. We understand that both the industry and the regulator concur with this approach.

Following statutory separation, each distribution business will prepare, on a standalone basis, statutory accounts which are compliant with UK GAAP for listed companies. Deloitte & Touche do not believe that preparation on this basis presents an obstacle to any of the PESs.

It is recognised that GAAP is dynamic and the RAGs will need to be monitored and updated in line with modifications to GAAP. It is simply not feasible (nor responsible) to freeze GAAP for the purposes of RAGs. The distribution businesses operate in a dynamic environment and the regulator needs to consider and accommodate such changes, and provide for them in the RAGs.

### **2.2 Activities**

Ofgem noted that "...a revised template which will show the level of detail required for the activity-based analysis will be included in the electricity distribution RAGs."

In order to drive consistency into the RA returns, it will be necessary for each distribution business to report their activities and services on the same basis.

As a result of the consultation process, each distribution business will need to break down its costs into the activities shown below as part of the annual RA reporting requirements:

- Network asset development
- Network asset management
- Repairs and maintenance, whether planned or unplanned
- Customer service
- Operations
- Metering
- IT
- Other overheads
- De-minimus
- Excluded services

### **3. ALLOCATION OF OVERHEADS:**

Despite its importance in the DPCR process, historically there has been very little guidance issued to companies to enable them to allocate overheads in ways that meet Ofgem's needs, especially in the allocation of capital ('capex') and of operating ('opex').

Differences in approach to overhead allocation across the PESs have two potential impacts on the quality of information returned to Ofgem. Such differences could distort the benchmarking of :

- costs broken down into activities; and
- capital expenditure.

Both Ofgem and the PESs recognise that this is a vital issue for DPCR purposes.

#### **3.1 Allocation of overheads**

Deloitte & Touche believe that changes in accounting policies and techniques, as well as newly separated company structures will reduce the amount of allocation of overheads required to complete the RAs. On that basis, Ofgem should adopt a watching brief as the entire industry is in a different shape to that which existed at the time of the last DPCR.

There is:

- more separation resulting in a significantly reduced allocation of central corporate overheads;
- a management responsibility on the distribution businesses to operate a profitable business, thereby reducing the likelihood that the business bears costs that are not fully warranted; and
- full application of FRS-15.

#### **3.2 Basis for guidelines – activity reporting**

Deloitte & Touche's guideline on allocation of overheads stems from the premise that allocations should be carried out on the basis of a 'reasonable' estimate of the different workloads or underlying activities. Allocations should reasonably reflect the cost of services. Disclosures and explanations of all exceptions should be required.

To create transparency in the allocation of overheads, Deloitte & Touche's recommendation builds on the principles introduced earlier in the paper, especially:

1. The requirement for a clear definition of the activities that a distribution business is expected to perform, along with guidelines that address the types of cost that should be included in each class of activity. Therefore, *each distribution business will be required to capture the activity costs as agreed and report these to Ofgem annually in the RA return.*
2. The need for network operating businesses which are external to the statutory entity of the licence holder, but fall within the FRS-8 definition of a related party, to report costs in line with the activity definitions outlined.

The two additional principles above drive some extended transparency into the area of overhead allocation. FRS-15 then provides the underlying rule for defining which costs are capex and which costs are opex.

Deloitte & Touche believe that activity reporting with additional rules for allocation of costs into these activities will make benchmarking of costs between PESs more transparent.

## 4. INTERNAL RECHARGES AND SERVICE LEVEL AGREEMENTS

### 4.1 Guideline on Internal Recharges

Regulated industries need to provide appropriate assurance and information to the regulator relating to internal recharges and thereby demonstrate that there is no cross-subsidy from one part of the organisation to another. Transparency in internal recharging is vital in allowing the regulator to monitor activities. Therefore the RAGs must include a framework for transacting with related and third-parties, and for the subsequent reporting of such transactions.

Deloitte & Touche's proposal to Ofgem outlines the following principles for incorporation into the RAGs:

- The over-arching principle is that of *disclosure of all related party transactions under the auspices of FRS-8.*
- However, the *UK GAAP definition of FRS-8 should be adjusted for RAGs purposes* in the following respects:
  - if a company, with which a distribution business has a business relationship or contract, would be considered to be a related party of any company within the Group entity then it shall be considered a related party of the regulated business. Therefore, *if an associated company is considered to be a related party of the parent company but not directly an associate of the Regulated business, it will still be considered a related party for regulatory reporting purposes.*
  - although FRS-8 relates only to material transactions, *additional disclosures will be required to allow the regulator to conduct its duties.* Such disclosures under FRS-8 will be required *for all individual transactions which exceed the following benchmarks:*
    - Total expected value of the individual contract is 0.5% of the regulated business turnover for the year immediately preceding, or
    - £500,000.

The following should also be provided:

- A detailed structure which identifies and explains all the material related party transactions.
- A flowchart showing the business process used to allocate internal and related party transactions. This should include a summary of the procedures adopted by the Directors to ensure they comply with the Companies Act 1989. These guidelines build on those established by OFWAT in RAG 5.03.
- A disclosure of the margins obtained on each transaction, in order to arrive at a 'true cost' to the distribution business;

- The proposed treatment of each transaction, i.e. to be capitalised or not; and
- The accumulated total value of inter-group contracts.

#### **4.2 FRS-8 and market testing**

FRS-8 (Related Party Transactions):

- defines related parties;
- dictates the treatment and disclosure of inter-group transactions; and
- requires transactions to be on an arm's length basis.

Supporting documentation should transparently demonstrate the arm's length basis of the contract. Deloitte & Touche do not consider that this will be unduly onerous as it is also a requirement of the Condition 12 or 14 of the PES Licence regarding separation.

#### **4.3 Market testing**

The following are examples of market testing techniques that can be used. They have been ranked in order commencing with the most desirable method:

- |               |   |   |
|---------------|---|---|
| Market tender | - | unlimited market exposures and conducted in accordance with EU procurement rules                                |
| Market tender | - | selection enquiry of known players who have a proven produce/service in the market                              |
| Benchmarking  | - | using published figures (including appropriate quantity discounts) to benchmark the relevant service providers. |

When evaluating the tenders presented, appropriate weighting should be assigned to the price.

Having considered a number of variables, price must represent at least 50% of the judgement criteria.

Management should then give appropriate weighting to other factors such as quality of service, dependability, etc.

#### 4.4 Detailed information required to assess Internal Recharges

In the absence of proven market-testing, where distribution businesses enter into SLAs with related parties (as defined by FRS-8,) the underlying basis of recharging should be consistent across the companies.

In the programme of visits and comparisons performed by Deloitte & Touche, the following areas have been identified:

<b>Service</b>	<b>Basis</b>
Building costs	Specific costs or floor space allocation.
Call centre	Specific or % of calls received.
IT and Data Management Systems	Specific or most appropriate of number of users or customer records.
Employee costs (eg pensions)	Specific or based on salary costs.
Head office costs (directors, insurance, admin, legal, accounting, HR)	Specific allocation for legal and insurance, for all other costs where specific allocation is not possible then a basket allocation approach should be developed.

NB where the basis is considered to be specific then third party evidence should be available to support this cost.

#### 4.5 Detail required to support arm’s length arrangements

In order to comply with FRS-8 the following information should be provided for each material item. The regulator could expand the requirement to disclose all “small contract values” as well. Paragraph 6 of FRS-8 presents a number of disclosure requirements required for related party disclosures. We have built on such disclosures in the following table.

<b>1. Service</b>	A description of the transaction i.e. Service received or provided.
<b>2. Company providing service</b>	Names of the transacting related party including a description of the company structure.
<b>3. Terms of supply</b>	State how prices were established eg competitive tendering.
<b>4. Value</b>	Of service received or supplied. Showing a breakdown to its component parts.
<b>5. Date of contract and date of expiry</b>	Options to extend or renew.
<b>6. Method of selection of appointee: with explanation of why contract awarded internally</b>	Include details of market tests conducted.
<b>7. Details of advertisement of contract</b>	
<b>8. Date of advertisement and number of respondents</b>	
<b>9. Number of invitees to tender</b>	
<b>10. Number of tenders submitted</b>	Basis for exclusion or withdrawal.
<b>11. State method of evaluation</b>	Method and number of comparators with ranking.
<b>12. Balance sheet</b>	Amounts due to or from the related party at the balance sheet date.
<b>13. Amounts written off</b>	Amounts written off by the related party in respect of the contract including interest.

Related party disclosures should be divided into these relevant transaction categories as identified under FRS-8, Paragraph 19.

#### 4.6 Building on OFWAT RAG 5:03

In March 2000, OFWAT published a revised set of Regulatory Accounting Guidelines for Transfer Pricing in the water industry (RAG 5.03). In essence, the OFWAT RAGs address many issues in common with this project.

The OFWAT principle that addresses internal recharging is outlined below, (with Deloitte & Touche’s insertion of ‘distribution business’ to adapt it for this purpose)

*“The principles of this guideline are that:*

- *The distribution business pays a fair price for products and services received;*

- *Transfer prices for transactions between the distribution business and associate or associated companies are based on market price or less. Where no market exists these are based on cost;*
- *Market testing is used to establish market prices for supplies, works and services provided to the distribution business; and*
- *Costs are allocated in relation to the way resources are consumed.*

*Distribution businesses will be required to demonstrate, through the application of these principles, the basis of arm's length trading and that no cross-subsidy exists."*

*OFWAT also states that "...the primary principle is that Internal Recharges should be based on market price or less and that market price should be determined by market testing."*

Unless otherwise stated within this report, Deloitte & Touche recommend that distribution businesses should comply with OFWAT's RAG 5.03. This will foster a consistent approach throughout the regulated industry.

## **5. CAPITALISATION POLICIES**

### **5.1 Introduction**

The guidelines must provide for meaningful comparison of capital expenditure across the distribution businesses. The responses to the Deloitte & Touche questionnaire<sup>1</sup> indicated a range of inconsistent approaches to capitalisation. An example is line and cable repairs:

- All PESs capitalise line and cable repairs in different ways, based on a combination of length, whether underground or overhead, capacity or a percentage of faults.

There are also inconsistencies in the way that overheads are capitalised. This is further impacted by the changes in structure of some of the licensed distribution businesses.

### **5.2 Guideline on capitalisation**

With the application of UK GAAP for a London Stock Exchange listed company, FRS-15 (Tangible Fixed Assets) should be the guiding principle for capitalisation. FRS-15 sets out very specific scenarios for the types of expenditure and indirect overheads that should be / can be capitalised.

Additional disclosure guidelines are necessary to alleviate inconsistencies in application of FRS-15 found by Deloitte & Touche during their visits to the PESs. The guiding principles are:

- Reporting on an activity basis for licensed Distribution businesses, including those who have services provided to them by external companies. Activity reporting on the basis set out will facilitate comparison with PESs that outsource network operations.
- A set of detailed guidelines that, in so far as is possible, reduce inconsistencies in information returns.

### **5.3 Detailed Rules for Capitalisation**

#### **5.3.1 Guideline on capitalising projects**

Deloitte & Touche believe that the application of FRS-15 to the fully separated distribution businesses will provide Ofgem with information that is more meaningful and more readily interpretable than has been the case in the past, therefore this guideline is derived from FRS-15:

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<sup>1</sup> Issued prior to the Industry Workshop – 26 September 2000

- Any third party revenue or contribution should be offset against the asset value and the net asset value depreciated over the life of the asset.
- Capitalisation of interest will be allowable under the auspices of FRS-15, i.e. an ‘all or nothing’ basis.
- Changes in asset lives, where any asset has a Net Book Value > £500,000, shall be disclosed separately within the ‘Notes to Accounts.’ The estimated financial effect of the changes in the current period must be reflected in the Regulatory Accounts for that period.

### **5.3.2 Guideline on asset improvements (where the asset has been previously capitalised)**

Deloitte & Touche have considered a number of approaches to this aspect of capitalisation and the rationale for the following treatment is that it appears appropriate, is in accordance with UK GAAP and compliant with this requirement will not be onerous for distribution businesses. Therefore, Deloitte & Touche recommend that:

Asset improvements may be capitalised if the expenditure is:

*> £1000 and / or causes one or more of the following:*

- *The complete replacement of an asset*
- *The partial replacement of an asset under the auspices of a planned asset replacement programme in order to achieve replacement of the asset in total*
- *Modifications which increase the revenue earning capacity of an asset*
- *Modifications that extend the existing or bring a new life-cycle to an asset*

### **5.3.3 Guideline on capitalising lines and cables**

Although all PESs have used a number of different bases in this area, and there are historic reasons for having chosen that policy, Deloitte & Touche believe that the existing inconsistency can be alleviated by implementing a set policy across the industry that is based on FRS-15, not on an arbitrary length of line or cable.

Each of Deloitte & Touche’s recommendations is intended to present the industry and Ofgem with a guideline that avoids distorting information, the creation of perverse incentives and other behaviours.

The rationale for this is that any other treatment allows for inconsistencies due to the difficulties in comparing the characteristics of all fourteen networks. For example, there is no viable direct comparison between the costs of maintaining the London Power Networks distribution system, which is almost entirely underground in one of the most expensive cities in the world, and that of Scottish & Southern Energy, which is primarily above ground in wear-intensive atmospheric conditions.

Therefore, Deloitte & Touche recommend that the following work on cables and lines should be capitalised:

*All capital work which meets the definition of FRS-15 on underground cables and all overhead lines of any length.*

#### **5.3.4 Guideline on small tools and equipment**

In order to drive consistency into the accounting for this category of expenditure:

*All small tools and equipment with a value > £500 should be capitalised.*

#### **5.3.5 Wayleaves and easements**

*All wayleaf expenditure should be expensed in the year incurred. All 'one-off' payments to obtain legal rights of way should be capitalised and depreciated over the shorter of*

- the period of rights; or
- the life of the asset to which the wayleave pertains.

#### **5.3.6 Meter re-certification**

*Meter re-certification should be treated as an extension of the life of an asset owned by the distribution business. Therefore all costs directly attributable to this activity should be capitalised.*